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TAGS: ECON EINV EFIN KMCA CE
SUBJECT: SRI LANKA: 2007 GDP GROWTH REPORTEDLY 6.8%; FITCH
DOWNGRADES SOVEREIGN CREDIT RATING

REF: A. 07 COLOMBO 536 B. 07 COLOMBO 1305 C. COLOMBO 120

¶1. (SBU) Summary: Sri Lanka continued its healthy economic growth in 2007, reporting a 6.8% increase in real gross domestic product for the year. Weaknesses in the government's statistical methodology suggest the actual growth figure may have been lower, probably closer to 6%. The reported outcome was below the 7.5% the government had projected going into the year, but exceeded the Asian Development Bank (ADB) expectation that renewed war would bring growth down to 6%. Total GDP was $32 billion, yielding per capita income of about $1,600. For 2008, the Central Bank of Sri Lanka forecasts growth to be around 7%, whereas the ADB once again expects 6%. On April 2, Fitch Ratings downgraded Sri Lanka's sovereign credit rating from BB- to B+, citing increased risk from inflation, budget deficit, and worsened terms of trade arising from soaring oil prices. The Fitch downgrade reflects the fact that, despite the economy's overall resilience to the conflict, it has very little leeway to weather a global economic downturn that could hit exports, bring down remittances, and dry up the external credit that has helped the government finance its chronic deficits. End summary.

GDP REPORTEDLY UP 6.8% IN 2007...

¶2. (U) On March 28, Sri Lanka's Department of Census and Statistics (DCS) released gross domestic product and other macroeconomic data for 2007 showing that Sri Lanka's economy grew by 6.8% in 2007. Though down nearly 1% from the revised 2006 GDP growth figure of 7.7%, the 2007 result demonstrated the economy's continued resilience to the ongoing civil conflict. Total GDP was $32 billion, bringing per capita income up by 14% to $1,600. The Central Bank noted that this outcome marked the first time Sri Lanka has recorded GDP growth above 6% for three straight years.

... BUT MAY HAVE BEEN CLOSER TO 6%

¶3. (SBU) The DCS statistics are not wholly reliable, as the department uses unsophisticated data collection methodology and as a result has to fill in many blanks with guesses. With the government regularly announcing unrealistically ambitious growth targets, and defensively lashing out when outside observers suggest that the economy is not performing as well as the government claims, there is

pressure for DCS to embellish its numbers. Until mid-2007, the more competent Central Bank produced Sri Lanka's GDP calculations, based on DCS surveys of economic activity combined with data from other sources such as industry bodies. A few years ago, DCS began releasing its own calculation of GDP figures; DCS figures routinely came in a few tenths of a percent higher than the Central Bank numbers. For example, for 2006, DCS reckoned GDP growth at 7.7%, whereas the Central Bank stated it was 7.4%. (Note: Ref A cited the Central Bank figures, which we believed were more accurate.) When the Central Bank stopped releasing its own GDP figures in 2007, it told us it had done so because it considered the DCS figures accurate and having two sets of figures was confusing.

¶4. (SBU) We have heard from multilateral development bank contacts who have worked with DCS that its statistical methodology is "outdated and simplistic" and that its task is further compromised by poor private sector responsiveness to DCS's economic surveys. This contact cited the fisheries sector as an example: DCS is unable to actually track how many fish of what value are caught, so it relies on indicators like the increase in the number of fishing boats and an imputed increase in productivity to infer a quantity of growth in the sector. Similarly, a former Central Bank statistician recently wrote in an English-language newspaper that she had noted to DCS seemingly inconsistent figures that the agency had difficulty explaining. She cited a reported 9% growth rate in the construction sector despite a decline in cement availability and a reported 7.8% growth in domestic trade even though all categories of domestically traded goods recorded growth below 7%.

¶5. (SBU) Post also noted some unlikely numbers in the DCS results for 2007. For the first half of the year, DCS reported an annual GDP growth rate 6.2% (ref B). For the second half, it reported that the economy grew at a rate of 7.3%. DCS reported growth of 7.6% for

the fourth quarter, reporting double digit growth in the tea, fisheries, hotels, communications, banking, and finance sectors. These second half and fourth quarter figures strike us as implausibly high.

¶6. (SBU) For the record, since the DCS figures are probably still fairly accurate for comparative purposes, the following are the sectoral breakdowns reported for 2007: Services and manufacturing were the main drivers to growth. Services, which account for about two thirds of GDP, grew by 7.1%. Within services, the main contributors to growth were import/export trade, retail trade, port services, telecommunications, and finance. Tourism recorded a 12% decline, a direct result of the escalated conflict (ref C). The manufacturing sector (including apparel), which accounts for about 19% of GDP, grew by 6.4%. Agriculture, which contributes about a tenth of GDP, was up 3.3%. Rice, the staple cereal, declined after two years of record growth. Tea production declined, yet had record earnings due to higher global prices. Rubber production increased and benefited from high global prices.

PROSPECTS FOR 2008: THE SAME 6-7% RANGE

¶7. (SBU) The Central Bank forecast 7% growth in the Financial and Monetary Sector Road Map it released in January 2008. The Asian Development Bank, in its recent 2008 Asian Development Outlook, predicted the Sri Lankan economy in 2008 would grow by 6%. The ADB expects growth to be held back by a slowdown in private sector investment, weakening performance of the garment sector, and higher oil prices. The ADB cited the economic slowdown in the United States and the EU and escalation in the conflict as added downside risks to economic growth. Weather has also begun to look like a limiting factor for 2008 growth. Heavy rains have caused floods that appear to have damaged 15-30% of Sri Lanka's rice crop.

FITCH SOVEREIGN CREDIT RATING DOWNGRADE REFLECTS INFLATION, BUDGET AND TRADE DEFICITS

¶8. (U) On April 2, Fitch Ratings downgraded Sri Lanka's sovereign credit rating from BB- to B+, four tiers below "investment grade."

It cited Sri Lanka's "increased vulnerability...to adverse shocks associated with rising inflation, persistently large fiscal deficits and worsened terms of trade due to soaring oil prices in the context of greater government recourse to commercial and market-based financing." Fitch stated "increases in inflation and domestic interest rates have led to greater foreign-currency borrowing by the government." (Note: Although Sri Lanka's overall debt-to-GDP ratio declined slightly in 2007 to 85.8%, its external debt load increased from 43.4% to 44.1% of GDP.) Fitch noted that repayments on foreign currency debt in 2008 will amount to $1.5 billion. Despite the Central Bank's tighter monetary policy, Fitch "expects inflation to remain relatively high, and...believes it will prove challenging to reduce inflation significantly without inducing a sharp slowdown in economic growth that would expose weaknesses in public finances." Like the ADB, Fitch judged "a lasting and secure settlement of the conflict is unlikely to be realized in the near term, and the risk of disruptive terrorist attacks, despite the military gains made against the LTTE, cannot be wholly discounted. Moreover, with the management of the conflict being the overriding priority of the President and government, fiscal reforms and other economic policy issues are accorded less attention."

¶9. (SBU) The Central Bank in a press release dismissed Fitch's concerns, as it did when Standard & Poor's not long ago downgraded its sovereign credit rating outlook for Sri Lanka to "negative." The Central Bank stated that reserves, remittances, and foreign direct investment would be more than sufficient to cover the country's debt service. A New York-based securities analyst who follows Sri Lankan debt told Econoff that the Fitch downgrade would perhaps add a little to the cost of Sri Lankan debt, which currently yields over 10%, but was likely already mostly factored in. He noted though that some institutional investors would have to stay away from the debt at the new lower grade because their investment guidelines would limit how far below investment grade they can go.

COMMENT: GROWTH IS REAL, BUT WITH PEACE
WOULD BE HIGHER AND BETTER DISTRIBUTED

¶10. (SBU) While the government may have yielded to the temptation to pad its GDP growth statistics in the absence of solid data, a look around the capital, the thriving Western Province, and even the formerly sleepy Southern Province shows that the economy continues its remarkable resilience in the face of the conflict and the Rajapaksa government's anti-private sector bias. Cargo ships are lined up into and out of Colombo Port. Tall buildings are going up around Colombo. Road, rail, and port construction is underway in the South. Shoppers are in the markets, new cars are on the streets, and investors are looking at projects from renewable energy to domestic aviation. The shame is only that conflict has restricted this relative prosperity to only the West and the South. If the rest of the country was peaceful and growing at comparable rates, overall growth would easily hit the 8% level Sri Lanka needs to make real progress against its remaining poverty.
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